<u>Testimony of Michael D. Calhoun</u>
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Before the U.S. House Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit

The New Regulatory Guidance on Subprime Hybrid Mortgages:
Regulators and Response
<u>March 27, 2007</u>

Chair Maloney, Ranking Member Gillmor, and members of the Committee, thank you for holding this hearing to focus on regulatory actions related to subprime hybrid mortgages. These mortgages have had, and will continue to have, a significant negative impact on consumers, and we appreciate the opportunity to comment on the problem and proposed solutions.

My name is Michael Calhoun, and I serve as the President of the Center for Responsible Lending (CRL) (www.responsiblelending.org). CRL is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL began as a coalition of groups in North Carolina that shared a concern about the rise of predatory lending in the late 1990s.

CRL is an affiliate of Self Help (www.self-help.org), which consists of a credit union and a non-profit loan fund. For the past 26 years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans. Self-Help has provided over $5 billion of financing to over 50,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the country, with an annual loan loss rate of under one percent.

Before I took my current position with CRL, I worked in leadership roles in Self-Help, including overseeing our secondary marketing operations, where we generated funds for home lending by selling our mortgages as investments to other parties. I highlight this previous role, because I think it is important for you to understand that I have direct lending experience with a subprime lender. In fact, Self Help began making home loans to people with less-than-perfect credit in 1985 when that was unusual in the industry. We believe that homeownership represents the best possible opportunity for families to build wealth and economic security, allowing them to take their first steps into the middle class.

Since 2001, CRL has conducted a great deal of careful research on mortgage lending in the subprime market. We have looked at the costs of predatory lending and a number of issues involving excessive fees, unfair pricing and the disparate effects of abusive practices on African Americans, Latinos, senior citizens and rural homeowners. Three months ago, we issued a report showing that subprime mortgages are resulting in massive foreclosures. We found that nearly 20 percent of subprime mortgages made during the past two years have already failed or will end in foreclosure and loss of the family's home. That's one in five final foreclosures, representing the irrevocable loss of a home in every instance. In the report, we identified hybrid mortgages—also known as "2/28s," "3/27s," and "exploding" adjustable-rate mortgages—as one of the primary culprits behind this epidemic of home losses.

Today, with the market turmoil surrounding subprime lending, our concerns have been affirmed by many sources. In one example, the investment bank Lehman Brothers recently issued an analysis on subprime performance that, referring to subprime mortgages made in 2006, estimated that "cumulative defaults may run as high as 30 percent."[1] This level of home losses would be catastrophic, representing the worst disaster in the mortgage market since the Great Depression.

Federal law governing abusive lending practices is severely outdated, leaving consumers with scant protections against these losses. Until the federal financial regulators issued the Proposed Statement on Subprime Mortgage Lending we are discussing today (hereafter referred to as "the March 8 Statement" or "the Statement"), there were no meaningful restrictions on the lax underwriting and poor business practices that have produced the exploding ARMs that have flooded the subprime market.[2] We commend the regulators for issuing this Statement, which explicitly charges depository institutions with responsibly underwriting subprime loans by evaluating the borrower's ability to repay the debt after the interest rises to the fully-indexed rate.[3]

The March 8 Statement is an important step in the right direction, but regulators, policymakers, lenders and investors all need to take actions to assist subprime borrowers in distress and ensure that this debacle never happens again.

The lending industry is opposing stronger consumer protections, saying that such protections would reduce access to mortgages. The truth is that this market has been thwarting homeownership rather than supporting it. Between 1998 and 2006, only an estimated 1.4 million first-time home buyers purchased their home with a subprime loan. When those loans are stacked against past and projected foreclosures resulting from subprime mortgages, this market is producing a significant net loss of homeownership for almost one million families. I will elaborate on this point later in the testimony.

My two main messages to you today are these: One, there is a difference between increasing the volume of home loans and expanding homeownership. We have no quarrel with charging a reasonable interest rate premium on subprime home loans, but we take issue with an industry that routinely offers loans that are unsustainable. To truly build wealth through homeownership, we must make it clear that reckless lending practices will not be tolerated.

Second, we cannot in good conscience abandon the homeowners who have been harmed by reckless subprime loans. The market is making corrections now, but these corrections will do nothing for families who have already lost their homes, and those who already received exploding ARMs and will therefore lose their homes in the future. In addition, the incentives to make damaging loans may lie dormant in the short-term, but they continue to exist, and, unless appropriate actions are taken, will inevitably trigger further abuses in the future.

I respectfully submit six simple and effective policy solutions to stop destructive lending practices in the subprime market and return to sound lending practices.

1. Restore safety to the subprime market by finalizing the Statement with an "ability to repay" standard for all subprime loans. In the March 8 Statement, federal regulators explicitly offer greater protections against the risks posed by exploding ARMs. The Statement says that an institution's analysis of a subprime borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. We strongly urge the regulators to finalize these provisions as soon as possible.[4]

2. Require the Federal Reserve Board to act, or address abuses through the Federal Trade Commission. Current federal law—the Home Ownership and Equity Protection Act of 1994 (HOEPA)—governing predatory lending is inadequate and outdated. However, through HOEPA, Congress mandated that the Federal Reserve Board address mortgage lending abuses on all loans through regulation and gave it broad authority to carry out this responsibility. To date the Board has not used this authority. The Board must address abusive lending practices to prevent another foreclosure crisis in the future. Given the Board's record of inaction, Congress should give parallel authority to the Federal Trade Commission to address harmful practices that have gone on too long.

3. Require government-sponsored enterprises to stop supporting abusive subprime loans. Recently Freddie Mac announced that it would no longer purchase mortgage-backed securities backed by abusive subprime loans, but Fannie Mae has not made a similar commitment. Fannie Mae should follow Freddie Mac's lead and refuse to purchase these securities, the Office of Federal Housing Enterprise Oversight (OFHEO) should prohibit their purchase, and the U.S. Department of Housing and Urban Development (HUD) should stop providing credit for these securities under HUD's affordable housing goals.

4. Hold all industry players accountable for their actions. Lenders, brokers, servicers, investors and trustees should stem the tide of foreclosures by proactively modifying loans to make them sustainable. Lenders should also have greater accountability for brokers' actions, and brokers should have a fiduciary duty to serve the best interests of their clients. And when investors purchase loans, they should assume legal liability for loans that are abusive or predatory.

5. Strengthen existing bankruptcy law to assist homeowners harmed by subprime foreclosures. Many struggling borrowers have no chance for recovery except through bankruptcy, but current bankruptcy law singles out the home mortgage loan as the one debt for which the bankruptcy court cannot provide relief. To assist homeowners who are trying to recover from harmful subprime loans, a modification to the bankruptcy code is necessary and appropriate.

6. Strengthen protections against destructive home lending by passing a strong national anti-predatory lending bill. HOEPA has not kept up with the evolution of abuses in the market, and needs to be updated and strengthened. As HOEPA does today, any new federal law must preserve the right of the states to supplement the law, when necessary, to address new or locally-focused lending issues.

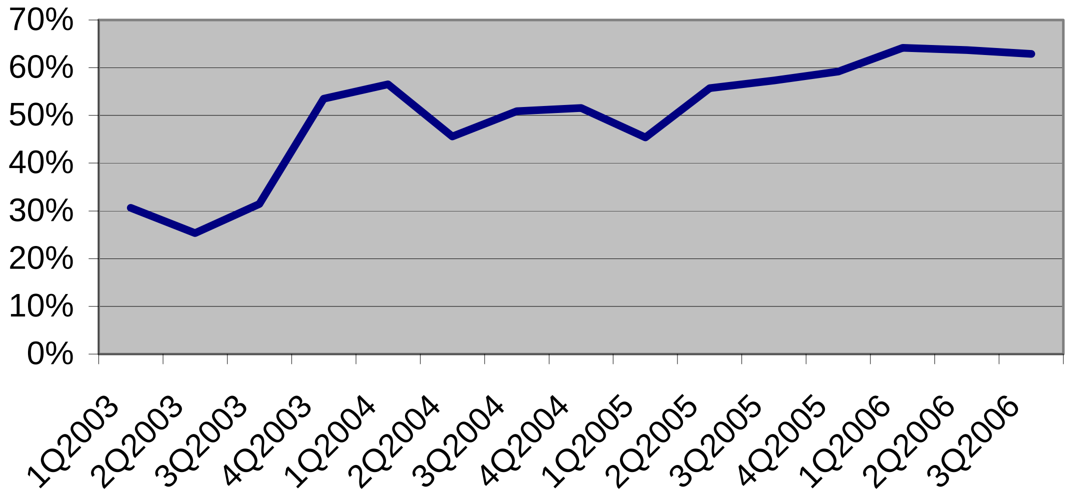
Lower-income and credit-challenged homeowners can become successful homeowners if given reasonable mortgages. For millions of families, sustainable homeownership will ultimately make the difference between merely surviving between paychecks or building savings for a better future. This subcommittee can play a powerful, positive role in shaping a healthy subprime market that will increase the economic strength of this country by contributing to homeownership that moves families forward instead of pushing them back.

I. Foreclosures in the Subprime Market

Appendix A provides background information on the growth and development of the subprime market. For our purposes today, I will focus on today's most pressing concern: the recent wave of foreclosures in the subprime market, and the factors that drive these foreclosures, with emphasis on high-risk loan products.

A. Foreclosures in the Expanding Subprime Market
In the United States, the proportion of mortgages entering foreclosure has climbed steadily since 1980, with 847,000 new foreclosures filed in 2005.[5] In 2006, lenders reported 354,554 new foreclosure filings for the fourth quarter alone, 47.5 percent higher than the fourth quarter of 2005.[6] In the past 18 months, there have been frequent stories in the media about risky lending practices and surges in loan defaults, especially in the subprime market.[7]

Subprime Foreclosure Starts as a Percent of Total Conventional Foreclosure Starts



Source: MBA National Delinquency Surveys

The graph above shows that foreclosure filings on subprime mortgages now account for over 60 percent of new conventional foreclosure filings reported in the MBA National Delinquency Survey (A "conventional" loan is one that is not insured or guaranteed by a government agency). This fact is striking given that only 23 percent of current originations are subprime, and subprime mortgages account for only 13 percent of all outstanding mortgages.

Late last year we published a report that represents the first comprehensive, nationwide research conducted on foreclosures in the subprime market. The report, "Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners," is based on an analysis of over six million subprime mortgages, and the findings are disturbing. Our results show that despite low interest rates and a favorable economic environment during the past several years, the subprime market has experienced high foreclosure rates comparable to the worst foreclosure experience ever in the modern prime market. We also show that foreclosure rates will increase significantly in many markets as housing appreciation slows or reverses. As a result, **we project that 2.2 million borrowers will lose their homes and up to $164 billion of wealth** in the process. That translates into foreclosures on one in five subprime loans (19.4 percent) originated in recent years. Taking account of the rates at which subprime borrowers typically refinance from one subprime loan into another, and the fact that each subsequent subprime refinancing has its own probability of foreclosure, this translates into projected foreclosures for **more than one-third of <u>current</u> subprime borrowers**.

Another key finding in our foreclosure report is that subprime mortgages typically include characteristics that significantly increase the risk of foreclosure, regardless of the borrower's credit. Since foreclosures typically peak several years after a loan is originated, we focused on the performance of loans made in the early 2000s to determine what, if any, loan characteristics have a strong association with foreclosures. Our findings are consistent with other studies, and show what responsible lenders and mortgage insurers have always known: Mortgages with built-in payment increases or those based on poorly-documented borrower income substantially boost the risk of foreclosure. For example, even after controlling for differences in credit scores, these were our findings for subprime loans made in 2000:

- Adjustable-rate mortgages had 72 percent greater risk of foreclosure than fixed-rate mortgages.
- Mortgages with "balloon" payments had a 36 percent greater risk than a fixed-rate mortgage without that feature.
- Prepayment penalties are associated with a 52 percent greater risk.
- Loans with no documentation or limited documentation of the applicant's income were associated with a 29 percent greater risk.
- And buying a home with a subprime mortgage, versus refinancing, puts the homeowner at 29 percent greater risk.

The report used Moody's Economy.com housing appreciation forecasts to help us project subprime foreclosure rates in every metropolitan statistical area in the United States. Our research shows that local markets with high housing appreciation in recent years have protected the market from the consequences of these risky and poorly underwritten loans. Consequently, as housing prices slow or reverse, those areas are likely to experience marked increases in subprime foreclosure rates.[8]

A full copy of the "Losing Ground" foreclosure study appears on CRL's website at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189. In addition, we include information on the disparate impacts of these foreclosures in Appendix B.

II. Factors Driving Foreclosures in the Subprime Market

A. Risky Products: 2/28 "Exploding" ARMs

Subprime lenders have been routinely marketing the highest-risk loans to the most vulnerable families and those who already struggle with debt. Because the subprime market is intended to serve borrowers who have credit problems, one might expect the industry would offer loan products that do not amplify the risk of failure. In fact, the opposite is true. Lenders seek to attract borrowers by offering loans that start with deceptively low monthly payments, even though those payments are certain to increase. As a result, many subprime loans can cause "payment shock," meaning that the homeowner's monthly payment can quickly skyrocket to an unaffordable level.

Unfortunately, payment shock is not unusual, but represents a typical feature that comes with the overwhelming majority of subprime home loans. Today the dominant type of subprime loan is a hybrid mortgage called a "2/28" that effectively operates as a two-year "balloon" loan.[9] This ARM comes with an initial fixed teaser rate for two years, followed by rate adjustments in six-month increments for the remainder of the term of the loan.[10] Commonly, this interest rate increases by between 1.5 and 3 percentage points at the end of the second year, and such increases are scheduled to occur even if interest rates in the general economy remain constant; in fact, the interest rates on these loans generally can only go up, and can never go down.[11] This type of loan, as well as other similar hybrid ARMs (such as 3/27s) have rightfully earned the name "exploding" ARMs.

One would hope that this type of loan would be offered rarely and judiciously. In fact, hybrid ARMs (2/28s and 3/27s) and hybrid interest-only ARMs have become "the main staples of the subprime sector."[12] Through the second quarter of 2006, hybrid ARMs made up 81 percent of the subprime loans that were packaged as investment securities. That figure is up from 64 percent in 2002.[13]

The risks posed by these loans are magnified further because they are designed to generate refinances. These loans typically begin with a low introductory interest rate that increases sharply after a short period of time (one to three years) and fails to account for escrows for required taxes and insurance. The very design of these loans forces struggling homeowners to refinance to avoid unmanageable increased payments.

While multiple refinances boost volume for lenders, these transactions often provide only temporary relief for families, and almost inevitably lead to a downward financial spiral in which the family sacrifices equity in each transaction. These dangerous subprime hybrid ARM loan products and the ensuing refinances make a high rate of foreclosures not only a risk, but a certainty for far too many families. And the likelihood of foreclosure will only increase as housing prices slow and accumulated equity is no longer available to refinance or sell under duress.

As regulators receive comments on their Statement, some in the industry are likely to argue that consumers demand these types of loans and should carry all the responsibility for receiving unsuitable loan products. Through our experience at Self Help and CRL, we have seen that homeowners with subprime ARMs or other types of risky loans were almost never given a choice of products, but were instead automatically steered to these loans, and were given little or no explanation of the loan's terms. Mortgage brokers and lenders are the experts, and consumers should be able to trust them for sound advice and a suitable loan.

It is not hard to find examples of trust that was betrayed. In a Senate hearing held last month, two homeowners struggling with abusive subprime loans appeared as witnesses before the Banking, Housing and Urban Affairs Committee. In one instance, a widow and mother from North Carolina was told by her broker that her refinance would be a fixed-rate loan with an affordable payment. Instead, she was pressured into accepting an adjustable-rate mortgage that started at 10.4 percent, with an interest rate that can go as high as 16.4 percent. Her monthly payment, which does not include taxes and hazard insurance, requires 86 percent of her monthly income, leaving only $388 a month to support herself and her children. Another witness that appeared at the hearing, a retired administrator who lives on the south side of Chicago, trusted a broker who saddled her with a mortgage with monthly payments that now *exceed* her monthly income.[14]

Recently we informally contacted a few practicing attorneys in North Carolina and asked them to provide examples of inappropriate or unaffordable loans from their cases. In less than 48 hours, we received a number of responses, including the cases briefly described in Appendix C. We also are aware of cases in which the borrower requested a fixed-rate mortgage, but received an ARM instead. The industry itself has acknowledged that borrowers placed in subprime hybrid ARMs could have received fixed-rate loans, and that the rate difference is "commonly in the 50 to 80 basis point range", and often a fixed rate loan can have a lower interest rate and monthly payments than a stated income exploding ARM loan.[15] Thus, the high risk of these exploding ARM loans is unnecessary, as better alternative loans are available.

B. Loose Qualifying Standards and Business Practices

The negative impact of high-risk loans could be greatly reduced if subprime lenders had been carefully screening loan applicants to assess whether the proposed mortgages are affordable. Unfortunately, many subprime lenders have been routinely abdicating the responsibility of underwriting loans in any meaningful way.

Lenders today have a more precise ability than ever before to assess the risk of default on a loan. Lenders and mortgage insurers have long known that some home loans carry an inherently greater risk of foreclosure than others. However, by the industry's own admission, underwriting standards in the subprime market have become extremely loose in recent years, and analysts have cited this laxness as a key driver in foreclosures.[16] Let me describe some of the most common problems:

Not considering payment shock: Lenders who market 2/28s and other hybrid ARMs often do not consider whether the homeowner will be able to pay when the loan's interest rate resets, setting the borrower up for failure. Subprime lenders' public disclosures indicate that most are qualifying borrowers at or near the initial start rate, even when it is clear from the terms of the loan that the interest rate can (and in all likelihood, will) rise significantly, giving the borrower a much higher monthly payment.[17] In fact, it is not uncommon for 2/28 mortgages to be originated with an interest rate four percentage points under the fully-indexed rate. For a loan with an eight percent start rate, a four percentage point increase is tantamount to a 40 percent increase in the monthly principal and interest payment amount.

Failure to escrow: The failure to consider payment shock when underwriting is compounded by the failure to escrow property taxes and hazard insurance.[18] When lenders include escrow funds as part of the borrower's monthly house payment, they ensure that these funds are available when due, and they also make the true cost of the loan more transparent. Responsible lenders have always understood that establishing an escrow account is even more important for lower-income borrowers or those with high debt burdens and less disposable income. Yet, in stark contrast to the prime mortgage market, most subprime lenders make loans based on low monthly payments that do not escrow for taxes or insurance.[19] This deceptive practice gives the borrower the impression that the payment is affordable when, in fact, there are significant additional costs.

When homeowners are faced with large tax and insurance bills they cannot pay, the original lender or a subprime competitor can benefit by enticing the borrowers to refinance the loan and pay additional fees for their new loan. In contrast, it is common practice in the prime market to escrow taxes and insurance and to consider those costs when looking at debt-to-income and the borrower's ability to repay.[20]

Low/no documentation: Inadequate documentation also compromises a lender's ability to assess the true affordability of a loan. Fitch Ratings, the international ratings firm, recently noted "loans underwritten using less than full documentation standards comprise more than 50 percent of the subprime sector . . .." "Low doc" and "no doc" loans originally were intended for use with the limited category of borrowers who are self-employed or whose incomes are otherwise legitimately not reported on a W-2 tax form, but lenders and brokers have increasingly used these loans to inflate borrower incomes and put the borrower into an unaffordable loan.

Multiple risks in one loan: Regulators have expressed concern about combining multiple risk elements in one loan, stating that "risk-layering features in loans to subprime borrowers may significantly increase risks for both the…[lender] and the borrower."[21] Combining adjustable rates with built-in payment shock, prepayment penalties, and poor underwriting, as many of these loans do, profoundly increases the risk of failure.

C. Broker Abuses and Perverse Incentives

Mortgage brokers are individuals or firms who find customers for lenders and assist with the loan process. Brokers provide a way for mortgage lenders to increase their business without incurring the expense involved with employing sales staff directly. Brokers also play a key role in today's mortgage market: According to the Mortgage Bankers Association, mortgage brokers now originate 45 percent of all mortgages, and 71 percent of subprime loans.[22]

Brokers often determine whether subprime borrowers receive a fair and helpful loan, or whether they end up with a product that is unsuitable and unaffordable. Unfortunately, given the way the current market operates, widespread abuses by mortgage brokers are inevitable.

First, unlike other similar professions, mortgage brokers do not believe they have a fiduciary responsibility to the borrower who employs them. Professionals with fiduciary responsibility are obligated to act in the interests of their customers. Many other professionals already have affirmative obligations to their clients, including real estate agents, securities brokers and attorneys. Buying or refinancing a home is the biggest investment that most families ever make, and particularly in the subprime market, this transaction is often decisive in determining a family's future financial security. The broker has specialized market knowledge that the borrower lacks and relies on. And brokers hold themselves out to borrowers as a trusted adviser for navigating the complex mortgage market. Yet, in most states, mortgage brokers have no legal responsibility to refrain from selling inappropriate, unaffordable loans, or not to benefit personally at the expense of their borrowers.[23]

Second, the market, as it is structured today, gives brokers strong financial incentives to ignore the best interests of homeowners. Brokers and lenders are focused on feeding investor demand, regardless of how particular products affect individual homeowners. Moreover, because of the way they are compensated, brokers have strong incentives to sell excessively expensive loans.[24]

Experts on mortgage financing have long raised concerns about problems inherent in a market dominated by broker originations. For example, the chairman of the Federal Reserve Board, Ben S. Bernanke, recently noted that placing significant pricing discretion in the hands of financially motivated mortgage brokers in the sales of mortgage products can be a prescription for trouble, as it can lead to behavior not in compliance with fair lending laws.[25] Similarly, a report issued by Harvard University's Joint Center for Housing Studies, stated, "Having no long term interest in the performance of the loan, a broker's incentive is to close the loan while charging the highest combination of fees and mortgage interest rates the market will bear."[26]

D. The Role of Investors and Ratings Agencies

Lenders sometimes claim that the costs of foreclosing give loan originators adequate incentive to avoid placing borrowers into unsustainable loans, but this has proved false. Lenders have been able to pass off a significant portion of the costs of foreclosure through risk-based pricing, which allows them to offset even high rates of predicted foreclosures by adding increased interest costs. Further, the ability to securitize mortgages and transfer credit risk to investors has significantly removed the risk of volatile upswings in foreclosures from lenders. In other words, high foreclosure rates have simply become a cost of business that is largely passed onto borrowers and sometimes investors.

It is clear that mortgage investors have been a driving force behind the proliferation of abusive loans in the subprime market. Their high demand for these mortgages has encouraged lax underwriting and the marketing of unaffordable loans as lenders sought to fill up their coffers with risky loans. For example, approximately 80 percent of subprime mortgages included in securitizations issued the first nine months of 2006 had an adjustable-rate feature, the majority of which were 2/28s.[27]

Under these circumstances, CRL is among those calling for strong leadership from investors and other Wall Street players. There was a notable example of this recently, when Freddie Mac, one of the largest mortgage investors, announced a new policy to only buy subprime adjustable-rate mortgages (ARMs) -- and mortgage-related securities backed by these subprime loans -- that qualify borrowers at the fully-indexed and fully-amortizing rate. Freddie Mac is implementing this policy to protect future borrowers from the payment shock that could occur when their adjustable rate mortgages increase.

We applaud Freddie Mac's action, and Fannie Mae should follow suit by refusing to buy securities backed by high-risk subprime loans that hurt consumers and reverse the benefits of homeownership. The GSEs, with their public mission, should not be permitted to purchase loans to distressed or minority or low-to-moderate income families that do not meet an "ability to repay" standard.

Recently, as foreclosure rates have sharply increased, investors are looking more closely at underwriting practices that have produced foreclosure rates far higher than predicted. While the recent turmoil in the subprime market may force lenders to make some adjustments to accommodate investor concerns, it will not help those borrowers who are in 2/28s now, many of whom will lose their homes, their equity and their credit ratings when lenders foreclose on loans that never should have been made.

E. Federal Neglect

When Congress passed HOEPA in 1994, subprime loans made up only a very small share of the total mortgage market, and predatory lending practices were not nearly as prevalent as they were to become a few years later. It would have been helpful to update HOEPA to keep pace with the rashes of innovative predatory lending practices that occurred after the law passed, but with the pace of change in the mortgage market and the challenges of passing major legislation, that has not been—and never will be—feasible.

On the federal level, one regulatory agency was required to take action: the Federal Reserve Board. The Board's primary authority comes through HOEPA, which requires the Board to prohibit unfair or deceptive mortgage lending practices and to address abusive refinancing practices. Specifically, the Act includes these provisions:

> (l) DISCRETIONARY REGULATORY AUTHORITY OF BOARD.--
> (2) PROHIBITIONS.--The Board, by regulation or order, shall prohibit acts or practices in connection with--
> (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
> (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.[28]

While HOEPA generally applies to a narrow class of mortgage loans, it is important to note that Congress granted the authority cited above to the Board for all mortgage loans, not only loans governed by HOEPA (closed end refinance transactions) that meet the definition of "high cost." Each of the substantive limitations that HOEPA imposes refers specifically to high-cost mortgages.[29] By contrast, the authority granted by subsection (l) refers to "mortgage loans" generally.[30]

The legislative history makes clear that the Board's authority holds for all mortgage loans. The HOEPA bill that passed the Senate on March 17, 1994, and the accompanying Senate report, limited the Board's authority to prohibit abusive practices in connection with high-cost mortgages alone.[31] However, this bill was amended so that the bill that ultimately passed both chambers, as cited above, removed the high-cost-only limitation, and the Conference Report similarly removed this restriction.[32] The Conference Report also urged the Board to protect consumers, particularly refinance mortgage borrowers.[33]

In fact, the Board itself has acknowledged that it has broad authority to address abusive lending practices on any mortgage loan. In 2001, when the Board was considering amendments to HOEPA, it published a proposed rule and commentary in the Federal Register that included this passage (original emphasis added by the Board):

> Section 129(*l*) of TIL [Truth in Lending] authorizes the Board to prohibit acts or practices to curb abusive lending practices. The act provides that the Board shall prohibit practices: (1) In connection with *all mortgage loans* if the Board finds the practice to be unfair, deceptive, or designed to evade HOEPA: and (2) in connection with *refinancings of mortgage loans* if the Board finds that the practice is associated with abusive lending practices or otherwise not in the interest of the borrower.[34]

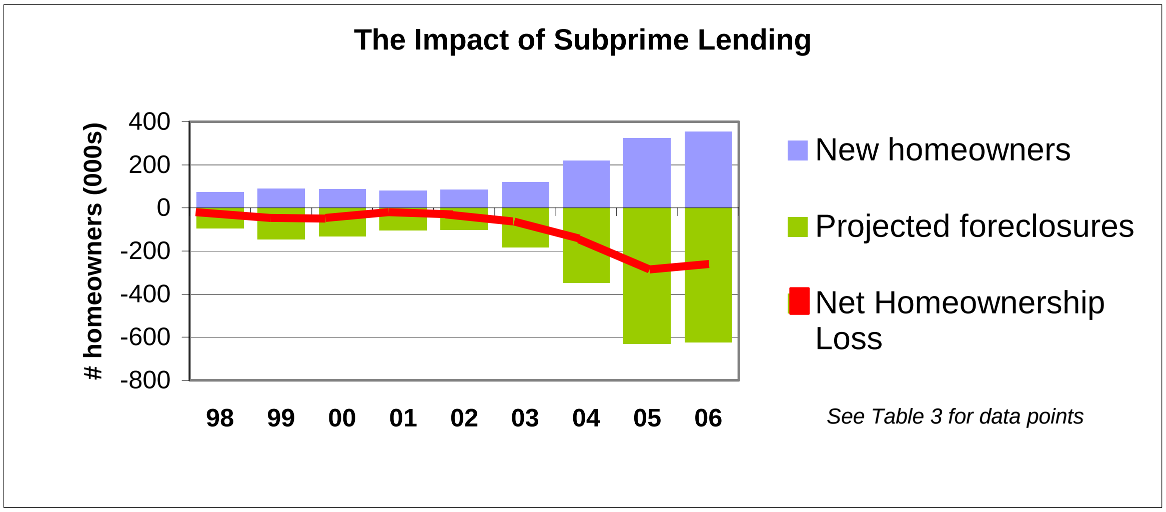
Unfortunately, although the Board has this affirmative duty under TIL accompanied with a broad authority to prohibit acts and practices, and it has publicly affirmed that it applies to all home loans, the Board has not applied that authority in any meaningful fashion.[35] This point was emphasized just last week in a Senate Banking hearing, where Roger Cole, the Board's director of banking supervision, admitted that the Board has failed to act promptly to address the crisis in subprime lending. Mr. Cole said, "Given what we know now, yes, we could have done more sooner."[36] In the same hearing, an official from the FDIC agreed that the current home losses will certainly get worse.[37]

III. The Results: Net Losership

Taken together, all the factors I just discussed have converged to create a "perfect storm" of foreclosures. Industry representatives have often asserted that a higher rate of foreclosures is the price to pay for expanded homeownership. Unfortunately, subprime lending has not resulted in any net gain in homeownership; in fact, there has been a loss.

Over the past nine years, the subprime market has produced more than two trillion dollars in home loans, but only a relatively small portion of these loans have supported first-time ownership—the majority of subprime loans are refinances. Between 1998 and 2006, only an estimated 1.4 million first-time home buyers purchased their home with a subprime loan.[38] Yet over that same time period, there have been many more foreclosures on all subprime loans. In our recent research on subprime foreclosures, CRL estimated that over 2.2 million borrowers who obtained subprime loans will lose or have already lost their home to foreclosure. When we update the analysis to include subprime originations for fourth quarter 2006, the total number of projected subprime foreclosures increases to 2.4 million.[39]

That means that since 1998, subprime lending has led to a net loss of homeownership for almost one million families. In fact, as shown in the following chart, a net homeownership loss occurs in subprime loans made in every one of the past nine years.[40]



These results are not surprising given the high rate of foreclosures in the subprime market combined with the high rate of refinances. Until the recent boom in housing prices, the great majority of subprime loans were refinances.[41] Even in 2006, subprime refinance loans accounted for more than half (56 percent) of all subprime loans made. These loans, obviously, do not contribute to new homeownership. Additionally, a significant proportion of subprime purchase mortgages are obtained by existing homeowners buying another home, not first-time homebuyers.[42] Again, this does not increase homeownership levels. **We estimate that overall since 1998, only nine percent of subprime loans have gone to first-time homebuyers and hence led to increased homeownership (Table 1).**

Table 1: Estimated New Homeownership from Subprime Lending

	Total Subprime Loans Originated[43]	Subprime Loans Used for Home Purchases		Estimated Subprime Loans to First-Time Homebuyers[44] (Homeownership Gain)	
		Number	% of all SP Loans	Number	% of all SP Loans
1998	962,273	293,012	30%	73,253	8%
1999	1,132,280	357,234	31%	89,309	8%
2000	911,369	350,604	38%	87,651	10%
2001	918,557	323,424	35%	80,856	9%
2002	1,046,072	343,530	33%	85,883	8%
2003	1,505,854	483,229	32%	120,807	8%
2004	2,219,547	876,721	40%	219,180	10%
2005	3,259,908	1,297,443	40%	324,361	10%
2006	3,219,749	1,416,690	44%	354,172	11%
TOTAL 98-06	**15,175,609**	**5,741,887**	**38%**	**1,435,472**	**9%**

Second, as discussed earlier, a sizeable percentage of subprime loans end in foreclosure—a much higher proportion than prime loans. **We estimate that 15.6 percent of all subprime loans originated since 1998 either have ended or will end in foreclosure and the loss of homeownership.** These statistics include homeowners who bought their homes with prime loans, but lost their home through abusive subprime refinance loans.

Table 2: Estimated Lost Homeownership from Subprime Lending

	Total Subprime Loans Originated	Projected Subprime Foreclosures [45] (Homeownership Loss)	Projected Cumulative Foreclosure Rate[46]
1998	962,273	94,750	9.8%
1999	1,132,280	144,567	12.8%
2000	911,369	133,126	14.6%
2001	918,557	105,464	11.5%
2002	1,046,072	102,252	9.8%
2003	1,505,854	181,464	12.1%
2004	2,219,547	348,345	15.7%
2005	3,259,908	632,302	19.4%
2006	3,219,749	624,631	19.4%
TOTAL 98-06	**15,175,609**	**2,366,901**	**15.6%**
CRL original foreclosure projection based on 2006 statistics for 1Q-3Q only[47]	*14,446,135*	*2,225,442*	*15.4%*

Comparing the homeownership gain from subprime lending to first-time homebuyers (Table 1) to the loss of homes caused by subprime foreclosures (Table 2), we see a net loss of homeownership every year since 1998, totaling almost one million families.

Table 3: Net Impact on Homeownership from Subprime Lending

	Estimated Subprime Loans to First-Time Homebuyers (Homeownership Gain)	Projected Subprime Foreclosures (Homeownership Loss)	Net Homeownership Gain or (Loss)
1998	73,253	94,750	(21,497)
1999	89,309	144,567	(55,258)
2000	87,651	133,126	(45,475)
2001	80,856	105,464	(24,608)
2002	85,883	102,252	(16,369)
2003	120,807	181,464	(60,657)
2004	219,180	348,345	(129,165)
2005	324,361	632,302	(307,941)
2006	354,172	624,631	(270,459)
TOTAL 98-06	**1,435,472**	**2,366,901**	**(931,429)**

Lost Homeownership for African Americans and Latinos
Subprime lenders frequently assert that subprime loans have been a boon for African-American and Latino families in particular, but that's not the case: Both populations also experienced a net loss of homeownership due to these loans.

Table 4. Impact of 2005 Subprime Lending on Homeownership by Race/Ethnicity

	African-Americans	Latinos	Other Borrowers
2005 Subprime Originations[48]	505,286	570,484	2,244,617
Number of Subprime Loans to First-Time Homebuyers (Homeownership Gain)	50,925	72,981	200,455
Projected Foreclosures on 2005 Subprime Loans (Homeownership Loss)[49]	98,025	110,674	423,723
Net Homeownership Gain or (Loss)	**(47,101)**	**(37,693)**	**(308,061)**

The implications of this analysis are even more disturbing in light of the difficulties of recovering from a foreclosure. Research indicates that homeowners who give up homeownership for any reason can take more than a decade to become homeowners again—and even longer for minorities.[50] Thus, the massive foreclosures resulting from subprime lending not only represent a loss of immediate opportunity for wealth-building, but also a lost opportunity that can carry forward for many years.

IV. Solutions

Congress has a long history of strong policies to support homeownership, but that task has become more complicated than ever. Supporting homeownership continues to involve encouraging fair lending and fair access to loans. But supporting homeownership also means refusing to support loans that are abusive, destructive and unnecessarily risky.

A few years ago, the problem of subprime foreclosures likely would have received scant attention from policymakers, since subprime mortgages represented only a small fraction of the total mortgage market. Today subprime mortgages comprise almost one quarter of all mortgage originations. The merits of this expanding market are widely debated, but one point is clear: Subprime mortgage credit—and the accompanying foreclosures—have become a major force in determining how and whether many American families will attain sustainable wealth. This is particularly true in urban areas, where wealth-building is a critical issue.

There are simple, known solutions to help preserve the traditional benefits of homeownership and to address many of the problems I have mentioned today. Here I discuss our recommendations:

1. Restore safety to the subprime market by imposing a borrower "ability to repay" standard for all subprime loans. The federal banking and credit union regulators should adopt the proposed Statement that calls on federally regulated banking institutions to make sure lenders underwrite loans to the fully indexed, fully amortizing rate. We also recommend that they require that lenders escrow for property taxes and hazard insurance on subprime loans. Further, the Statement points out the problems with no-doc loans, and the final Statement should affirmatively require that lenders verify and document all sources of income using either tax or payroll records, bank account statements or other reasonable third-party verification.

2. Require the Federal Reserve to act, or address abuses through the FTC. HOEPA, the major federal law designed to protect consumers against predatory mortgage lending, has manifestly failed to stem the explosion of harmful lending abuses that has accompanied the recent subprime lending boom. In HOEPA, Congress required the Federal Reserve Board to address these problems for all mortgage loans, but to date the Board has not done so. It should do so now. Given the Board's record, Congress should seriously consider also enlisting the Federal Trade Commission's assistance in addressing abuses that have gone on too long.

3. Require government-sponsored enterprises to stop investing in abusive subprime loan securities. Currently Fannie Mae is purchasing mortgage-backed securities that include high-risk subprime loans. Providing liquidity to lenders who market abusive, high-risk loans that are not truly affordable is clearly counter to its mission. Fannie Mae should follow Freddie Mac's lead and voluntarily stop investing in these securities. In addition, HUD should stop giving them affordable goals credit for purchasing these AAA securities (take them out of both the numerator and denominator in assessing the market), and OFHEO should prohibit the agencies from adding these securities to their portfolios.

4. Hold industry players accountable for their actions. Lenders, brokers, servicers, investors and trustees should stem the tide of foreclosures by proactively modifying loans to make them sustainable. There is no longer any dispute that brokers and lenders have placed borrowers into loans that set them up for foreclosures, and the secondary market provided key support and high demand for this reckless lending. The parties who enabled this crisis should be held fully accountable for minimizing the damage today by taking a proactive role in changing the terms of 2/28s and other abusive subprime loans. Specific remedies will vary depending on the homeowner's situation, but examples of positive actions include converting loans to fixed-rate mortgages with affordable interest rates, writing down principal loan balances, and waiving prepayment penalties.

Brokers are involved in 70 percent of subprime originations, but perverse economic incentives encourage brokers to act counter to the interests of the borrowers and allow lenders to look the other way. One necessary step is to make lenders liable for all acts and omissions of the brokers that occur while the brokers are placing people in abusive loans.

These responsibilities should continue along the lending chain. To preserve homeownership, the trustees representing these nameless, faceless secondary market investors should be required to answer for the transgressions of the brokers, lenders and servicers of the loans that form mortgage-backed securities. The bottom line is that victims of abusive practices should be able to fight to stay in their homes, and the brokers and lenders should not be able to hide behind the secondary market, nor should the secondary market be able to hide behind the holder in due course rule to literally leave borrowers out in the cold.

<u>5. Strengthen existing bankruptcy law to assist homeowners harmed by subprime foreclosures</u>. Currently many struggling borrowers have no chance for recovery except through bankruptcy. The problem is that as currently enacted, the Bankruptcy Code favors home mortgage lenders over all other secured and unsecured creditors. Written at a time when home mortgages were nearly all fixed-interest rate instruments with low loan-to-value ratios and were rarely the source of a family's financial distress, bankruptcy law singles out the home mortgage loan as the one debt for which the bankruptcy court is powerless to provide relief. Since that time, the mortgage market has shifted considerably. Subprime lending practices of the last six years, which have relied on property appreciation, and in many cases appraisal fraud, have left many borrowers with mortgages larger than the value of their homes. If these homeowners cannot restructure these debts, then they cannot get back on their feet financially. For this reason, a modification to the bankruptcy code is necessary and appropriate.

<u>6. Strengthen protections against destructive home lending by passing a new national anti-predatory lending bill</u>. Federal law has clearly not kept up with the abuses in the changing mortgage market. HOEPA needs to be extended and updated to address the issues that are driving foreclosures today. Even should this happen, we need to realize that it is impossible for any single law to cover all contingencies or to anticipate predatory practices that will emerge in the future. Any new federal law must therefore preserve the right of the states to supplement the law, when necessary, to address new or locally-focused lending issues. While HOEPA is weak, it did recognize the limits of federal law, and therefore functions as a floor, not a ceiling. If HOEPA had not allowed states to take action, today's disastrous levels of foreclosures would be even worse.

Thank you very much for the opportunity to testify before you today. I would be happy to answer any questions you may have.

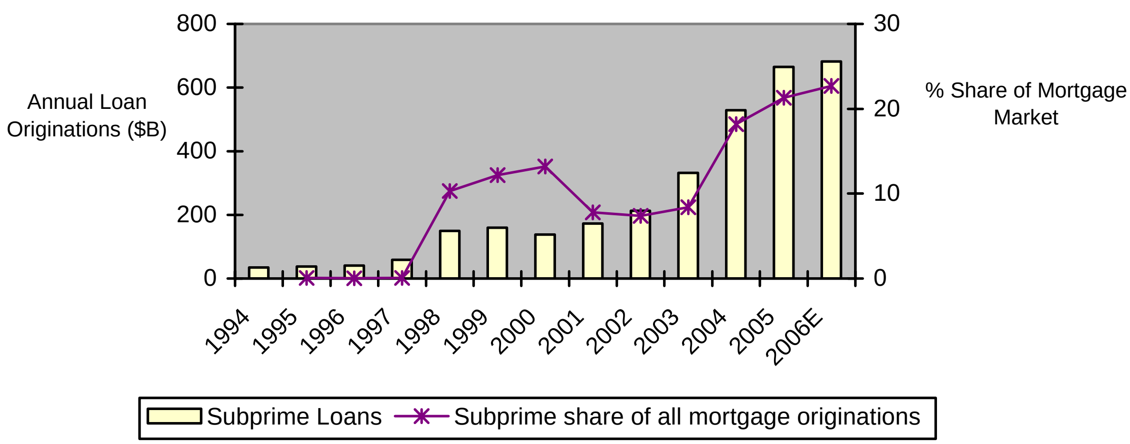
APPENDIX A

Background on the Subprime Market and the Evolution of Predatory Lending[51]

The subprime market is intended to provide home loans for people with impaired or limited credit histories. In addition to lower incomes and blemished credit, borrowers who get subprime loans may have unstable income, savings, or employment, and a high level of debt relative to their income.[52] However, there is evidence that many families—a Freddie Mac researcher reports one out of five—who receive subprime mortgages could qualify for prime loans, but are instead "steered" into accepting higher-cost subprime loans.[53]

As shown in the figure below, in a short period of time subprime mortgages have grown from a small niche market to a major component of home financing. From 1994 to 2005, the subprime home loan market grew from $35 billion to $665 billion, and is on pace to match 2005's record level in 2006. By 2006, the subprime share of total mortgage originations reached 23 percent.[54] Over most of this period, the majority of subprime loans have been refinances rather than purchase mortgages to buy homes. Subprime loans are also characterized by higher interest rates and fees than prime loans, and are more likely to include prepayment penalties and broker kickbacks (known as "yield-spread premiums," or YSPs).

Subprime Mortgage Market Growth and Share of Total Mortgage Market



Source: Inside Mortgage Finance

When widespread abusive lending practices in the subprime market initially emerged during the late 1990s, the primary problems involved equity stripping—that is, charging homeowners exorbitant fees or selling unnecessary products on refinanced mortgages, such as single-premium credit insurance. By financing these charges as part of the new loan, unscrupulous lenders were able to disguise excessive costs. To make matters worse, these loans typically came with costly and abusive prepayment penalties, meaning that when homeowners realized they qualified for a better mortgage, they had to pay thousands of dollars before getting out of the abusive loan.[55]

In recent years, when the federal government failed to act, a number of states moved forward to pass laws that address equity-stripping practices. Research assessing these laws has shown them to be highly successful in cutting excessive costs for consumers without hindering access to credit.[56] The market has expanded at an enormous rate during recent years even while states reported fewer abuses targeted by new laws.

APPENDIX B
Disparate Impacts of Foreclosures

The costs of subprime foreclosures are falling heavily on African-American and Latino homeowners, since subprime mortgages are disproportionately made in communities of color. The most recent lending data submitted under the Home Mortgage Disclosure Act (HMDA) show that over half of loans to African-American borrowers were higher-cost loans, a measurement that serves as a proxy for subprime status.[57] For Latino homeowners, the portion of higher-cost loans is also very high, at four in ten. The specific figures are shown below:

Share of Higher Cost Mortgages by Race
Based on 2005 Data Submitted Under the Home Mortgage Disclosure Act

Group	No. of Higher-Cost Loans	% for Group	% of Total
African American	388,741	52%	20
Latino	375,889	40%	19
White	1,214,003	19%	61

Given the projected foreclosure rate of approximately one-third of borrowers taking subprime loans in recent years, this means that subprime foreclosures could result in the loss of a home for approximately 12 percent of all recent Latino mortgage borrowers and 16 percent of African-American borrowers. If this comes to pass, it is potentially the biggest loss of African-American wealth in American history.

However, while the negative impact of foreclosures falls disproportionately on communities of color, the problem is not confined to any one group. In absolute terms, white homeowners received three times as many higher-cost mortgages as African-American borrowers, and therefore will experience a significant number of foreclosures as well.

APPENDIX C

To illustrate the unfortunate realities of inappropriate and unaffordable 2/28 adjustable rate mortgages (ARMs), recently the North Carolina Justice Center informally contacted a few practicing attorneys in North Carolina to provide examples from their cases. They received a number of responses, including these described below.

1. **From affordable loan to escalating ARM .**
   Through a local affordable housing program, a homeowner had a 7% fixed-rate, 30-year mortgage. A mortgage broker told the homeowner he could get a new loan at a rate "a lot" lower. Broker originated a 2/28 ARM with a starting rate of 6.75%, but told borrower that it was a fixed-rate, 30-year mortgage. At the 24th month, the loan went up to 9.75%, following the loan's formula of LIBOR plus 5.125% and a first-change cap maximum of 9.75%. Loan can go up to a maximum of one point every six months, with a 12.75% total cap. Now borrower cannot afford the loan and faces foreclosure.

2. **Temporary lower payments—a prelude to shock.**
   Homeowner refinanced out of a fixed-rate mortgage because she wanted a lower monthly payment. The homeowner expressly requested lower monthly payments that included escrow for insurance and taxes. Mortgage broker assured her that he would abide by her wishes. Borrower ended up in a $72,000 2/28 ARM loan with first two years monthly payments of $560.00 at a rate of 8.625%. This initial payment was lower than her fixed-rate mortgage, but it did not include escrowed insurance and taxes. After two years, loan payments increased every six months at a maximum one percent with a cap of 14.625%. At the time of foreclosure, the interest rate had climbed to 13.375% with a monthly payment $808.75. If the loan had reached its maximum interest rate, the estimated monthly payment would be close to $900.00.

3. **Unaffordable from the start.**
   Homeowner had a monthly payment of $625 and sought help from a mortgage broker to lower monthly payment. Broker initially said he could lower the payment, but before closing said the best he could do was roughly $800. He assured borrower that he could refinance her to a loan with a better payment in six months. Previously he had advised homeowner not to pay her current mortgage payment because the new loan would close before the next payment due date. In fact, closing occurred after the payment was due, and borrower felt she had to close. Loan was a 2/28 ARM with an initial interest rate of 11% and a ceiling of 18% at an initial monthly payment of $921. Interest at first change date is calculated at LIBOR plus 7%, with a 12.5% cap and a 1.5% allowable increase/decrease at each 6-month change date. First change date is June 1, 2008. By approximately the third payment, however, borrower could not afford mortgage payments and is now in default.

End Notes

[1] Mortgage Finance Industry Overview, Lehman Brothers Equity Research (December 22, 2006). From page 1: "Lehman's fixed income trading and research teams expect the prime markets to experience an orderly consolidation as loan volume, gain on sale margins and credit quality revert to 'normal' less robust levels in 2007. However, they are very cautious on subprime, projecting 30% losses over time on the 2006 vintage."

[2] *See* 72 Fed. Reg. 10533 (March 8, 2007) for the federal Interagency Proposed Statement on Subprime Mortgage Lending issued by the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Department of the Treasury and the National Credit Union Administration.

[3] *See* 72 Fed. Reg. 10533 (March 8, 2007) at 7-8, setting the following standard: "Prudent qualifying standards recognize the potential effect of payment shock in evaluating a borrower's ability to service debt. An institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. …This assessment is particularly important if the institution relies upon reduced documentation or allows other forms of risk layering."

[4] The Conference of State Banking Supervisors and the American Association of Residential Mortgage Regulators (AARMR) have issued a statement that they intend to issue draft model guidance for state regulators which will mirror the Federal regulators' Statement. We hope that each state will enact guidance that directs lenders to consider ability to repay before extending any home loan.

[5] The rate of new foreclosures as a percent of all loans rose from 0.13 in 1980 to 0.42 in 2005, as reported in the *National Delinquency Survey*, Mortgage Bankers Association. 2005 new foreclosure filings statistic from Realty Trac in *Home Foreclosures on the Rise*, MoneyNews (February 23, 2006) at http://www.newsmax.com/archives/articles/2006/2/23/134928.shtml.

[6] "More Than 1.2 Million Foreclosures Reported in 2006 According to RealtyTrac™ U.S. Foreclosure Market Report (January 25, 2007) http://biz.yahoo.com/prnews/070125/lath048.html?.v=87.

[7] See, e.g., Saskia Scholtes, Michael Mackenzie and David Wighton, "US Subprime Loans Face Trouble," *Financial Times* (December 7, 2006); "Nightmare Mortgages," *Business Week* (September 11, 2006); Vikas Bajaj and Christine Haughney, "Tremors at the Door, *New York Times* (January 26, 2007); Matthew Padilla, "Subprime's Grip Slips," *The Orange County Register* (January 28, 2997); and "Vikas Bajaj "For Some Subprime Borrowers, Few Good Choices," *New York Times* (March 22, 2007).

[8] As one example, in the greater Washington, D.C. area, projected lifetime foreclosure rates on subprime loans made from 1998 through 2001 are slightly over eight percent, but for subprime mortgages made in 2006, the projected foreclosure rate shoots up to nearly 23 percent.

[9] A balloon loan is one that is not repayable in regular monthly installments, but rather requires repayment of the remaining balance in one large lump sum. While 2/28s are not balloon loans, the impact of higher interest rates at the end of the two-year teaser rate period, resulting in higher monthly payments, may force a borrower to seek refinancing.

[10] See, e.g., *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, p. 2 Fitch Ratings Credit Policy (August 21, 2006).

[11] Here we are describing the 2/28 because it is by far the most common product in the subprime market, but the concerns are the same with the 3/27, which differs only in that the teaser rate remains in effect for three years.

[12] See, e.g., *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs,* p. 2 Fitch Ratings Credit Policy (August 21, 2006).

[13] *Structured Finance*, note 12.

[14] "Preserving the American Dream: Predatory Lending Practices and Home Foreclosures," U.S. Senate Committee on Banking, Housing, and Urban Affairs (February 7, 2007), at http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=248.

[15] January 25, 2007 letter from CFAL to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3.

[16] See e.g., Office of the Comptroller of the Currency, National Credit Committee, *Survey of Credit Underwriting Practices 2005.*The Office of The Comptroller of Currency (OCC) survey of credit underwriting practices found a "clear trend toward easing of underwriting standards as banks stretch for volume and yield," and the agency commented that "ambitious growth goals in a highly competitive market can create an environment that fosters imprudent credit decisions." In fact, 28% of the banks eased standards, leading the 2005 OCC survey to be its first survey where examiners "reported net easing of retail underwriting standards." *See also* Fitch Ratings, 2007 Global Structured Finance Outlook: Economic and Sector-by-Sector Analysis (December 11, 2006).

[17] For example, Fremont considered ability to repay based on initial payments due during the first year. Fremont Investment and Loan Prospectus, Fremont Home Loan Trust 2006-1 424B5 (April 4, 2006) available at: http://www.sec.gov/Archives/edgar/data/1357374/000088237706001254/d486451_all.htm. Option One qualified borrowers at the initial teaser rate. See Option One Prospectus, Option One Mortgage Loan Trust 2006-3 424B5 (October 19, 2006) http://www.sec.gov/Archives/edgar/data/1378102/000088237706003670/d581063_424b5.htm Fremont Investment and Loan Prospectus, Fremont Home Loan Trust 2006-1 424B5 (April 4, 2006), http://www.sec.gov/Archives/edgar/data/1357374/000088237706001254/d486451_all.htm, Morgan Stanley Prospectus, Morgan Stanley ABS Capital I Inc. Trust 2007-NC1 Free Writing Prospectus (January 19, 2007), http://www.sec.gov/Archives/edgar/data/1385136/000088237707000094/d609032_fwp.htm. Likewise, New Century's strongest underwriting practice, which is applied only to borrowers with a credit score under 580 and a loan-to-value ratio over 80 percent, is to evaluate the borrower's ability to repay the mortgage at an interest rate equal to the fully indexed rate minus one percentage point. "Best Practices Won't Kill Production at New Century," p. 3 *Inside B&C Lending* (November 24, 2006).

[18] See, e.g., "B&C Escrow Rate Called Low," *Mortgage Servicing News Bulletin* (February 23, 2005), "Servicers of subprime mortgage loans face a perplexing conundrum: only about a quarter of the loans include escrow accounts to ensure payment of insurance premiums and property taxes, yet subprime borrowers are the least likely to save money to make such payments… Nigel Brazier, senior vice president for business development and strategic initiatives at Select Portfolio Servicing, said only about 25% of the loans in his company's subprime portfolio have escrow accounts. He said that is typical for the subprime industry."

[19] See, e.g., "Attractive Underwriting Niches," Chase Home Finance Subprime Lending marketing flier, at http://www.chaseb2b.com/content/portal/pdf/subprimeflyers/Subprime_AUN.pdf (available 9/18/2006) stating, " Taxes and Insurance Escrows are NOT required at any LTV, and there's NO rate add!", (suggesting that failing to escrow taxes is an "underwriting highlight" that is beneficial to the borrower). 'Low balling' payments by omitting tax and insurance costs were also alleged in states' actions against Ameriquest. *See, e.g.* State of Iowa, ex rel Miller v. Ameriquest Mortgage Co. et al, Eq. No. EQCE-53090 Petition, at ¶ 16(B) (March 21, 2006).

[20] In fact, Fannie Mae and Freddie Mac, the major mortgage investors, require lenders to escrow taxes and insurance.

[21] See 71 Fed. Reg. 58609 (October 4, 2006) for the federal Interagency Guidance on Nontraditional Mortgage Product Risks, issued by the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Department of the Treasury and the National Credit Union Administration.; *See also See* 72 Fed. Reg. 10533 (March 8, 2007) at 7-8, stating that prudent underwriting, attention to the potential impact of payment shock and proper consideration of a borrower's ability to repay are "particularly important if the institution relies upon reduced documentation or allows other forms of risk layering."

[22] MBA Research Data Notes, "Residential Mortgage Origination Channels," September 2006.

[23] About one-third of the states have established, through regulation or case law, a broker's fiduciary duty to represent borrowers' best interests. However, many of these provisions are riddled with loopholes and provide scant protection for borrowers involved in transactions with mortgage brokers.

[24] Brokers earn money through up-front fees, not ongoing loan payments. To make matters worse for homeowners, brokers typically have a direct incentive to hike interest rates higher than warranted by the risk of loans. In the majority of subprime transactions, brokers demand a kickback from lenders (known as "yield spread premiums") if they deliver mortgages with rates higher than the lender would otherwise accept. Not all loans with yield-spread premiums are abusive, but because they have become so common, and because they are easy to hide or downplay in loan transactions, unscrupulous brokers can make excessive profits without adding any real value.

[25] Remarks by Federal Reserve Board Chairman Ben S. Bernanke at the Opportunity Finance Network's Annual Conference, Washington, D.C. (November 1, 2006).

[26] Joint Center for Housing Studies, "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations," Harvard University at 4-5. Moreover, broker-originated loans "are also more likely to default than loans originated through a retail channel, even after controlling for credit and ability-to-pay factors." Id. at 42 (citing Alexander 2003).

[27] *Inside B&C Lending*, Inside Mortgage Finance, p. 2 (November 24, 2006).

[28] 15 USC Section 1639(l)(2). Emphasis added.

[29] These limitations concern certain prepayment penalties, post-default interest rates, balloon payments, negative amortization, prepaid payments, ability to pay, and home improvement contracts. See subsections 129(c)-(i). High cost mortgages are those "referred to in section 103(aa)."

[30] Most subprime abuses occur with refinance loans rather than loans used to purchase a house (what HOEPA calls a "residential mortgage transaction", Sec. 152(aa)(1)). HOEPA's enumerated protections are limited to closed end refinance loans that meet the high cost standard. However, section (l) refers to "mortgage loans" generally, which would include purchase-money loans. The fact that section (l)(2) prohibitions are directed at two separate types of loans -- (A) those the Board finds to be unfair, deceptive, or designed to evade HOEPA, and (B) abusive refinancings -- provides evidence that subsection (A) includes purchase money loans as well.

[31] See S.1275, Section 129(i)(2): "PROHIBITIONS--The Board, by regulation or order, shall prohibit any specific acts or practices in connection with high cost mortgages that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section." Reported in 140 Cong. Rec. 3020, S3026. According to the Senate Report, No. 103-169, p. 27, "the legislation requires the Federal Reserve Board to prohibit acts or practices in connection with High Cost Mortgages that it finds to be unfair, deceptive, or designed to evade the provisions of this section."

[32] See House Conf. Rep. No. 103-652, p. 161, "the Board is required to prohibit acts and practices that it finds to be unfair, deceptive, or designed to evade the section and with regard to refinancing that it finds to be associated with abusive lending practices or otherwise not in the interest of the borrower."

[33] "The Conferees recognize that new products and practices may be developed to facilitate reverse redlining or to evade the restrictions of this legislation. Since consumers are unlikely to complain directly to the Board, the Board should consult with its Consumer Advisory Council, consumer representatives, lenders, state attorneys general, and the Federal Trade Commission, which has jurisdiction over many of the entities making the mortgages covered by this legislation.

"This subsection also authorizes the Board to prohibit abusive acts or practices in connection with refinancings. Both the Senate and House Banking Committees heard testimony concerning the use of refinancing as a tool to take advantage of unsophisticated borrowers. Loans were "flipped" repeatedly, spiraling up the loan balance and generating fee income through the prepayment penalties on the original loan and fees on the new loan. Such practices may be appropriate matters for regulation under this subsection." Id.

[34] 66 Fed. Reg. 65604, 65612 (December 20, 2001).

[35] The Board did cite section 129(*l*) during its rulemaking process in 2001-02 (including rules on due-on-sale clauses and evasion of HOEPA using open-end loans, although it appears that the authority to issue rules to prohibit evasion of HOEPA is independent); however, it did not propose any prohibitions of acts and practices that would apply to all home loans.

[36] Greg Hitt and James R. Hagerty, "Regulators are Pressed to Take Tougher Stand on Mortgages," *Wall Street Journal* (March 23, 2007).

[37] Hitt and Hagerty, note 36.

[38] In this analysis we set aside the fact that many of these borrowers could have received a more sustainable, conventional loan instead. A Freddie Mac researcher estimates 20 percent ("More Homeowners with Good Credit Getting Stuck with Higher-Rate Loans," *Los Angeles Times* [Oct. 24, 2005]), and others could have qualified for Federal Housing Administration loans.

[39] All figures in this analysis cover only loans to owner-occupants in the 50 states and the District of Columbia secured by a first-lien on a single-family home, condominium, townhouse, or a unit in a planned development. 1998-2004 figured derived from a proprietary database of subprime loans sold in the secondary mortgage market between 1998 and 2004. We modified 2005-2006 estimates from *Inside Mortgage Finance* and SMR Research Corporation to account for these criteria.

[40] Our numbers are conservative for two reasons. First, the proprietary database used consists of loans sold on the secondary market, and contains a higher proportion of subprime loans for home purchase than the overall subprime market. Second, the foreclosure projections were developed by CRL for its recent study *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowner (see full cite in note 46)*, and are based on conservative assumptions. Since that report was published in December 2006, other analyses suggest that foreclosures in the subprime market could actually be higher than CRL's projections. See, e.g., Lehman Brothers projects 30% losses over time for subprime loans originated in 2006 (*Mortgage Finance Industry Overview*, p. 4. Lehman Brothers Equity Research. December 22, 2006). If Lehman Brothers' foreclosure projections for 2006 are incorporated with CRL's projections for prior years, the total number of subprime foreclosures originated 1998-2006 climbs to 2.7 million households.

[41] Percent of subprime loans used for home purchase versus refinance were derived from the proprietary database for 1998-2004, and from SMR Research Corp and Inside Mortgage Finance for 2005-2006. The specific percentages by year are shown below. Totals may not add to 100% because a small percentage of loans in the database are listed as "other purpose"

	1998	1999	2000	2001	2002	2003	2004	2005	2006
% Subprime 'Refinance	67.2	66.9	60.4	64.8	67.1	67.9	60.5	60.0	56.0
% Subprime Purchase	30.5	31.6	38.5	35.2	32.8	32.1	39.5	40.0	44.0

[42] Douglas Duncan of the Mortgage Bankers Association testified on February 27, 2007 before the U.S. Senate Committee on Banking, Housing, & Urban Affairs that approximately 25% of subprime loans in 2006 were used by first-time homebuyers. See p. 5 at http://banking.senate.gov/_files/duncan.pdf.

[43] See note 39 for information on the source of these numbers.

[44] Our analysis applied the percentage of loans to first-time homebuyers cited by the MBA (25% --see Note 4) was applied consistently to all years 1998-2006. We believe this is a conservative approach, as the percentage of first-time homebuyers served in earlier years was probably below this figure.

[45] Ibid. Page 16. 2006 statistics have been adjusted upward to reflect inclusion of 4th quarter 2006 numbers, which were not included in original report published December 2006.

[46] Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners*, Center for Responsible Lending at 22 (December 2006), available at www.responsiblelending.org.

[47] See *Losing Ground*, note 46, Table 6 - p. 16.

[48] HMDA statistics for the total market are slightly lower than statistics shown in Tables 1 & 2, because not all subprime lenders are required to report under HMDA regulations.

[49] Assumes a 19.4% foreclosure rate as calculated for all 2005 subprime originations—see Table 2. This is a conservative estimate, as communities of color receive a disproportionate share of subprime loans, and the clustering of foreclosures in these markets is likely to cause a "feedback loop" that further depresses home values in the market and spurs additional foreclosures.

[50] Donald R. Haurin and Stuart S. Rosenthal, "The Sustainability of Homeownership: Factors Affecting the Duration of Homeownership and Rental Spells," HUD Office of Policy Development and Research at p. 43 (December 2004), available at http://www.huduser.org/Publications/pdf/homeownersustainability.pdf.

[51] Much of the following material originally appeared in the "Losing Ground" report cited in note 5.

[52] Ira Goldstein, *Bringing Subprime Mortgages to Market and the Effects on Lower-Income Borrowers*, p.2 Joint Center for Housing Studies, Harvard University (February 2004) at http://www.jchs.harvard.edu/publications/finance/babc/babc_04-7.pdf.

[53] Mike Hudson and E. Scott Reckard, *More Homeowners with Good Credit Getting Stuck in Higher-Rate Loans*, L.A. Times, p. A-1 (October 24, 2005). For most types of subprime loans, African-Americans and Latino borrowers are more likely to be given a higher- cost loan even after controlling for legitimate risk factors. Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending, (May 31, 2006) at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=29371010; S*ee also* Darryl E. Getter, *Consumer Credit Risk and Pricing*, Journal of Consumer Affairs (June 22, 2006); Howard Lax, Michael Manti, Paul Raca, Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 533, 562, 569, Housing Policy Debate 15(3) (2004).

[54] "Subprime Mortgage Origination Indicators," *Inside B&C Lending* (November 10, 2006).

[55] See, e.g., Eric Stein, *Quantifying the Economic Costs of Predatory Lending*, Center for Responsible Lending (2001).

[56] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law*, Housing Policy Debate, (15)(3): (2004); Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms* (2006) *available at* http://www.responsiblelending.org/pdfs/rr010-State_Effects-0206.pdf.

[57] The Home Mortgage Disclosure Act requires most lenders to file annual reports containing specified information about the "higher-cost loans" they originated. "Higher-cost loans" are those for which the APR exceeds the rate on a Treasury security of comparable maturity by 3 percentage points for first liens, and 5 percentage points for second liens. FRB analysis of 2005 HMDA data indicates that non-Hispanic whites received over 1.2 million higher-cost loans, compared to 388,471 for African-Americans and 375,889 for Latinos. Authors' calculations from data reported in Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Higher-Priced Home Lending and the 2005 HMDA Data*, Federal Reserve Bulletin A123, A160-161 (Sept. 8, 2006) http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf.